

The Coming Coronavirus Stagflation

How should you position yourself to prepare for the coming financial upheaval that may result from the coronavirus? The coronavirus already has caused a supply shock that we have yet fully to comprehend. We can't look into the future but we can look at the past. One possible way the interruption of Chinese manufactured goods will affect the economy is the way the oil shock of the 1970s did.

Back in the 1970s, all of the really smart economists used to [describe](#) the economy like a dial on a stereo that allowed you to adjust the balance between bass and treble. Economists believed one could achieve a perfect balance between inflation and unemployment by fiddling with the money supply until striking the magic combination of the two. Economists tend to favor central planning and technocratic approaches to economics because, let's be honest, nobody pays an economist to advise governments to do nothing.

But in the 1970s, something happened to upend this theory: Inflation *and* unemployment took off at the same time. The Federal Reserve continued fiddling with the dials but unemployment and inflation both got worse anyway. Why?

In theory, the presence of easy money in an economy encourages hiring more workers to accommodate business expansion. Scarce money makes high prices unsustainable at the cost of higher unemployment. Lower interest rates mean more money gushing through the economy but higher prices. Higher interest rates mean lower prices but higher unemployment. The trade-off is quite intuitive – until it isn't.

In 2018, China [accounted](#) for 28 percent of global manufacturing output. That number understates China's

importance because China specializes in mid to low-cost manufacturing. For another basis of comparison, China's share of the world's manufacturing accounts for more than its next two competitors combined, the United States at 16.6 percent and Japan at 7.2 percent.

There just isn't enough manufacturing capacity *outside of China* to make up for a loss in Chinese goods on a short-term basis. As [noted](#) by *The Wall Street Journal*, the epidemic, "has paralyzed large swaths of the country and led many businesses to remain shut for weeks." It further noted, "In a survey of 7,000 Chinese exporters released last week by China's Ministry of Commerce, 90 percent reported shipping difficulties and canceled orders caused by delayed deliveries and factory shutdowns." Worse yet, the "likelihood of a quick V-shaped recovery in the coming months is falling fast." So what has any of this got to do with the 1970s?

In the 1970s, when the oil shock touched off stagflation, oil [accounted for](#) a paltry 5 percent of GDP. Energy has generally been [excluded](#) from inflation calculations because of its volatile nature. But energy nevertheless affected other prices as an input into almost everything.

Compare and contrast that to what China makes and its important role in the consumer price index. The cost of items like televisions, appliances, furniture, and other manufactured goods has gone down and down for decades thanks to China's aggressive mercantilist approach which calls for underbidding competitors to gain market share advantages. The supply interruption of even a couple of months will cause shortages or price increases in items that have a significant effect on the formula for calculating inflation.

Like oil, Chinese goods go into everything. Many of those tiny little plastic parts that go into cars, toilets, and furniture are manufactured only in China. Our own automobile manufacturing [soon](#) could be impacted by an interruption of all

those inexpensive little gadgets that go into cars.

Once inflation resulting from shortages is confirmed, the Federal Reserve dutifully will adjust interest rates to slow price increases. But these price increases will not be the result of overheated demand.

The coronavirus price increase, like the oil shock price spikes, will be the result of fewer goods being bid upon by the same money. Inflation will also make it relatively more expensive to hold cash as a store of value. To balance risk, investors will start shifting out of cash into non-cash assets. Cash will become almost toxic as inflation continues to rise. The Federal Reserve will raise interest rates even more, hoping to get in front of the panic.

We can remember that inflation at the end of 1979 reached an eye-popping 11.3 percent. The next year, it increased *even more*, to a banana republic level of 13.5 percent. In 1981, inflation declined slightly but remained very high at 10.3 percent. The year-to-year numbers might be scary but even more scary was the cumulative compound-interest effect of four years of high inflation. To combat this inflation, the Federal Reserve [raised](#) interest rates to a whopping 19.04 percent at its peak in June 1981. That resulted in the recession and high unemployment of the early 1980s.

At the beginning of the 2008 financial crisis, the M2 [money supply](#) was around \$8 trillion. Today it is not quite double that amount at around \$15 trillion. The [GDP](#) in 2008 was around \$15 trillion. Today, it's not quite \$22 trillion. Thus, since 2008, the money supply has gone up almost twice as fast as the GDP. A lot of people feel secure holding cash as a hedge against uncertainty. That money isn't circulating and driving up prices. If that confidence ever cracks, there's a tidal wave of dollars waiting to come flooding back into the market.

Printing more dollars cannot make televisions magically appear

to offset closed factories in China. Televisions and everything else made in China will become harder to get and more expensive. It's just math.

As you find yourself buying bulk rice and toilet paper to prepare for the effect of coronavirus, let me offer one piece of advice: I can't tell you whether gold or real estate will be sound investments. But there's one can't-miss place for your money: pay off your credit cards.

The interest rate is only going to get higher as the uncertainty unfolds. If I'm wrong, you can always run your balances back up again when the crisis abates. If you're lending money, now might be a bad time to lock in a loan at a low, fixed-rate. These disruptions also tend to reveal too-good-to-be-true schemes for the frauds they are. Enron and Bernie Madoff, for example, were discovered as investors needed to withdraw cash out of their paper bonanzas. Now would be an excellent time to get out of that sketchy investment opportunity that seems to be defying gravity.

Oh, and wash your hands.

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